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# A Contained Depression

The economy may be turning the corner, but it's going to take a very long time to return to normal, predicts David Levy of the Jerome Levy Forecasting Center.

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If you're breathing a little easier because the Great Recession seems to be ending, consider this: the U.S. economy may remain in a "contained depression" for months or years to come. That warning comes from economist David Levy, chairman of the Jerome Levy Forecasting Center, an economic research and consulting firm. Levy originally coined the term to describe the recession of 1990-1991 and the subsequent halting, jobless recovery. Earlier this week he talked with *CFO* about the prospect of a similar scenario unfolding today. An edited version of the interview follows.

**What is the state of the economy today?**

We're in for a much longer period of contained depression [than we saw in the 1990s]. The single most overlooked observation about the U.S. economy in the postwar period is that balance sheets grew faster than incomes, decade after decade, both assets and liabilities. The problem is that asset values have to be justified by returns they can earn — or by expectations of future capital gains, and that's where you get into bubbles. What went on in the postwar period couldn't go on indefinitely. We were able to make it go on longer by dropping interest rates in the last two recessions, but we can't do that anymore. We have to shrink the value of assets on balance sheets and shrink liabilities. And that makes it very difficult for the economy to operate.

In fact, without the government sector, the economy would collapse. If you look at the second and third quarters of this year and analyze the sources of profits in the economy — and if you take government out of the picture — everything added up to a net loss, for the first time since the 1930s. But because we had an enormous injection of monetary wealth into the economy by the federal government, we were able to pump up profits and help them climb back to a much better level than they were at during the worst of the recession.

Fortunately, we're not going to have the 1930s all over again, although unemployment will be very high. The banking system will continue to function. The government at times may try to reduce the deficit, as the Japanese government has tried to do as they have been dealing with their own kind of contained depression. But every time you do it, profits are undermined, things get worse, and the deficit widens anyway — and then you feel pressure to do something to stimulate the economy. It's very hard not to run very large deficits.

In Japan, they wasted a lot of time actually getting to the financial problems and writing off bad loans and cleaning them up. We're doing a much better job, and it won't take us as long. But this is essentially the kind of problem we're dealing with. We're not going to see anything like the bubble-and-boom of the last couple of expansions or what we think of as more-normal business cycles.

**It sounds like we could be bumping along the bottom for quite a while.**

It's going to be a very difficult time. Unemployment is going to remain a chronically severe problem. We're going to average at least 8% over the next 10 years. And it could be worse. Even if we made progress from this point, we would do pretty well to knock unemployment down a percentage point a year, and we're nowhere near a position to do that. If we can keep the economy growing consistently, it will take at least four to five years just to get unemployment down to 6%.

**Do the banks have their balance-sheet problems worked out?**

The great majority of bad loans are yet to be recognized. We have seen the problems that came directly out of the structured-finance deals, but the actual defaults on mortgages are going to get much greater as incomes deflate and people are unemployed for longer periods of time. We'll see housing prices resume their decline at some point, and the collateral values are just not going to be there, and the ability to sell will remain compromised.

**Are we close to a time when the federal government can stop some of its stimulus efforts?**

[Private] investment is almost dead. Net investment in the U.S. economy came extremely close to zero. It had never been below 4% of GDP, and then it was almost zero. That's extraordinary. The government is replacing profits that are missing. That part can't go away anytime soon.

**Many of our readers are skeptical or critical of the stimulus. They feel too much money has been spent, and they're concerned about the deficit.**

The deficit was going to increase whether on purpose or by accident. Most of the deficit-widening was by accident. About $250 billion of the $700 billion stimulus was expected to be spent in 2009, but the deficit widened by many hundreds of billions, and most of that was as a result of the collapse of revenue. Corporate tax revenue collapsed and personal-income tax revenue collapsed. If we had not had the stimulus, perhaps we would have seen an even bigger decline. That is a part of the story that's not well understood.

People who have spent a good part of their careers concerned about financial management look at the government and say, 'All I know is that this is an organization that is putting out debt at a ridiculous rate. When is it going to end?' We're talking about something like 10 years before we clean out these problems. I think [the deficit] will break the post-World War II record of 109% of GDP. Maybe it will be 120%, maybe 140%. But we'll manage. This is going to come with a deflationary environment where we'll have very little inflation overall and maybe some periods of modest deflation. In that environment, interest rates are going to remain very low, and the actual debt service will not be that outlandish.

**Do you think the third-quarter numbers for corporate earnings and gross domestic product are largely irrelevant in terms of signaling recovery?**

No, they're relevant in terms of showing that we've made progress. Unemployment is not rising as fast, even though it is still rising. Some businesses are seeing a little pickup. Certainly the auto industry did a little better in the third quarter. But profits tend to be a leading indicator because they're one of the first things to change. Businesses react to the change in profits. Suddenly they're selling more, they're able to get a better price than they expected, and that motivates them to start changing their behavior, to stop cutting orders or order a little more. In this case, we do have a certain inertia. The only thing we can point to is that inventory investment, which has been substantially negative, can't continue to be that negative. As it comes up, that's a positive. You have to produce more to meet the same level of demand even if demand doesn't grow.

Many people think we're then going to get into a positive inventory cycle, but we [at the Levy Forecasting Center] disagree. Part of the reason this inventory decline has been so severe is that there has been a secular change. What's happened in the last year or so has made a lot of companies change their attitudes about the relative risk of stocking out or having too narrow a line of merchandise or supplies compared with the carrying costs, and tying up cash that they might need in an emergency or using too much of their credit lines.

**Some CFOs have told us recently that they're eager to seize opportunities as the economy starts to recover. They're thinking about making investments that they've been putting off. Do you have any advice for them?**

This is still a period where one has to be very cautious. We don't think this recovery is going to have much zip as we go into the New Year. Profits look like they're going to stall a bit.

My advice is to be very guarded about your financial position. It's worth paying a bit of a penalty to protect your access to cash and maintain liquidity. As for expansion, obviously if it's something you need [to do to stay competitive] you may have a compelling argument. But if it's a matter of taking advantage of a pickup in sales, I would err on the side of undershooting, because the downside risks remain huge. One thing we've learned over the last couple of years is that the kinds of problems we're dealing with can escalate in unexpected ways and do a great deal of damage. There will come a time to start looking at long-term expansion, but I would not be looking that way right now.

*David Levy will be speaking at the CFO Rising conference in March 2010 in Orlando. For more information, see http://www.cfo.com/conferences/.*